

AIR COMMAND AND STAFF COLLEGE

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The Lender's Mercy

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Abstract

During and after World War II, the United States manipulated the economic weakness of their ally, the United Kingdom, to increase US power and further national interests. Currently, as the world's largest debtor, the United States, is positioning itself in a similarly precarious position. This paper seeks to explore how the United States manipulated economic power to erode the global position of the United Kingdom through the Destroyers for Bases agreement, Atlantic Charter, Anglo-American loan, Bretton Woods agreement, and in the Suez Crisis. In today's environment the cumulative debt in the United States and other western economies provides similar leverage for nations financing government spending. Unfortunately, accounting principles dictate that all countries cannot run trade surpluses and hinders deleveraging possibilities. Meanwhile, rising powers such as China may utilize these economic weaknesses to manipulate international relations in their favor. Consequently, military leaders must understand the extent of current debt problems, their basic underlying principles, and the weaknesses it creates for US power projection. Only then can they provide the proper education for their forces, embrace the sequestration cuts of the Budget Control Act, shape the public opinion in the battle for defense versus entitlement spending, and bury inter-service rivalry.

In 1850 the United Kingdom controlled an astounding 59% of the world's wealth. By 1940 however, the once powerful nation's control of wealth plummeted to a mere 11% with the United States now commanding 49%.¹ Two world wars, national financial decisions, and the costs of running a global empire transformed the United Kingdom from the world's largest lender into the world's largest debtor. In the midst of the Second World War, Great Britain neared the end of its resources and funding capabilities. Prime Minister Winston Churchill grasped for hope and backing from the United States, their former colony and ally, across the Atlantic. Despite facing a threat to global peace and dealing with an ally, the United States methodically leveraged their economic position of power to their own advance national interests during negotiations with Great Britain. While US aid was beneficial to Great Britain against the near-term threat, as the lending nation the United States levied significant and cumulative concessions on the desperate nation with each agreement the British were forced to accept. When the fate of the world depended on cooperation, the United States heavily manipulated their economically weak ally. If the lending nation is not an ally and world peace is not hanging by a thread, financial aid between states will be even less kind.

In the modern world, the United States is expanding public debt at a furious pace. Efforts to reverse the growth of debt are negligible at best. The most significant efforts yet, the tumultuous deficit ceiling negotiations in the summer of 2011 resulting in the Budget Control Act, only served to reduce the debt's rate of expansion. If left to grow unchecked there is a distinct possibility that the United States, like Great Britain before her, may face loan conditions from foreign lenders which are unacceptable to national security. Despite this acknowledged and credible threat, military leaders continue to allude to military ineffectiveness due to budget cuts against an enemy which, unlike the deficit, has yet to materialize. While it might be nice to

wish away the deficits, unfortunately most Western style governments and even the private sector has similarly increased total debt which greatly complicates the situation and limits options going forward. The lack of a worldwide tangible threat, like Germany and Japan in the Second World War, has made the gradual increase in debt all the more insidious. In democracies, asking the public to accept the sacrifices necessary to decrease total debt without an easily identifiable and looming threat is near impossible. Eventually, confidence will be lost in the government's ability and/or willingness to repay their obligations. When this tipping point arrives, like Great Britain, the United States will be at the lender's mercy and it will be too late to make any choices but the painful. To prevent catastrophe, national policy makers must make the difficult choices today, and military leadership must take part in this conversation.

While US military generals are subservient to elected civilian leaders, they also retain an unparalleled amount of trust from the public at large. As sworn protectors of the United States, military leadership must rise to the occasion and assist in overcoming the national debt. If the military chooses to merely pander for increased funding it will only exacerbate the problem and is ultimately a breach of faith to their sacred oath. Instead of lowering themselves to the level of political rhetoric by shouting "hollow force", there are specific ways military leadership can contribute in advancing the national conversation. Progression from the near term outlook to the future will help identify the programs which ultimately dwarf military spending and truly endanger the nation.

In January of this year, the once world-dominating British navy begged the United States to allow one tiny frigate to accompany a show of power flotilla through the Strait of Hormuz.² Not a shot was fired between the United States and Great Britain in this century, yet the transfer of dominance is unquestionably complete. Understanding how the United States manipulated

economic forces to coerce Great Britain both during and after World War II provides a glimpse of threats facing the United States. The cumulative debt problem of all Western nations amplifies the danger significantly. Luckily, there is time to address the United States' fiscal difficulties and military leadership is duty-bound to play a role in shaping the national conversation. While preemptive economic restraint is difficult to accept, the consequences of inaction are insurmountable.

Assistance from an Ally

“Money often costs too much.” – Ralph Waldo Emerson³

As France collapsed on the Western front of Europe in June of 1940, the United Kingdom withdrew across the English Channel and waged the Battle of Britain as an island of solitude. While Winston Churchill sought aid and an alliance from the United States, he was only offered a one-sided agreement. The United States arranged to transfer fifty old American destroyers in exchange for ninety-nine year basing rights in Newfoundland and the Caribbean.⁴ Expanded basing options for the next century were an absolute bargain for the cost of a few US ships taken from mothball status. In the US-British relationship, this was only the first round of the financially endowed lending nation taking advantage of their economically weaker debtor. Churchill understood that the war equipment was of minimal value, but was very satisfied with the underlying thawing of cooperation between nations.⁵ In hindsight, he might have been less thrilled had he known the long term costs of partnership for the Empire.

As the war waged on, Britain continued to seek collaboration with the United States. On 11 March, 1941 the United States passed the 'Lend-Lease Act' sending invaluable money and supplies across the Atlantic. Despite the dire situation in Europe, the American congress could not pass up goading their once-colonial-masters by naming the bill House Resolution 1776.⁶

Lend-Lease provided much needed relief but the British continued to hope for US entry into the war and had to settle again in the summer of 1941. This time the agreement was the Atlantic Charter which outlined shared principles concerning the two nation's view of the world.⁷ While Prime Minister Churchill angled for wording which codified the United States' unwillingness to stand for German occupation of European nations, President Roosevelt used the conference to enact an anti-colonial agenda.⁸ As the nation with the upper hand, and now depended on for Lend-Lease, the United States levied their position to push verbiage which was harmful to Great Britain. One 'point' of the Atlantic Charter directly assaulted colonial rule by stating the two countries "respect the right of all peoples to choose the form of government under which they will live; and they wish to see sovereign rights and self-government restored to those who have been forcibly deprived of them."⁹ This statement alone seeded thoughts of self-rule in many of Great Britain's colonies after the war. Another 'point' attacked British economics by espousing free trade. Under the pre-war system Great Britain used trade agreements to monopolize trade with her colonies and the Commonwealth for tremendous financial gain. Although Britain was able to minimize the economic costs of this 'point' through astute wording changes, the American agenda was plain to see and placed Great Britain on untenable footing with her colonies.¹⁰

When the war ended, Britain was economically devastated, reeling from massive debt and now suddenly cut-off from Lend-Lease funding. The UK government's response was to turn back to the Americans for aid by sending John Maynard Keynes to Washington in 1945 seeking terms for additional loans. Using economic leverage yet again, the United States seized the opportunity to force Great Britain's hand in completing the liberalization of trade which was only implied in the Atlantic Charter. The resulting "Anglo-American loan" required Great

Britain to ratify the Bretton Woods agreement and remove preferential trade tariffs between Great Britain and her colonies.¹¹ This move opened the entire Empire for trade with the United States and simultaneously robbed Great Britain of a major economic advantage but the crushing amount of British debt left no options but for her to accept. By now, the United Kingdom had transitioned from the world's largest lender to the world's largest debtor and in 1947 the United States had acquired roughly 70% of the world's gold reserves.¹² The Bretton Woods system, which Great Britain was required to accept, assisted in the transfer of the international currency reserve status from the British Pound Sterling to the United States by pegging all world currencies against the dollar which was then fixed against gold. In effect, the British sacrificed national sovereignty over their currency. Although the British Pound was still defined as a reserve currency for transactions, this was a conciliatory effort and largely based on the pound's previous influence.¹³ Meanwhile, Britain's passing of Bretton Woods helped ensure worldwide participation in the agreement and the dollar gained the same prestige as gold. A second, and equally important provision of the agreement, was the founding of the International Monetary Fund (IMF) which served as an international arbiter of trade and exchange matters.¹⁴ Although all nations contributed funds to the IMF, by the end of a decade it would be wielded as yet another tool in the US arsenal to achieve national policy and subdue Great Britain.

The peace following the war did not bring solace to the people of Great Britain. Economic hardships continued and due to Bretton Woods, the world began to demand dollars instead of pounds as the nation struggled to shift production from war materials to consumer goods. Trade imbalances took their toll and in September of 1949 Great Britain was forced to devalue the pound by 30% against the dollar and hence gold.¹⁵ While the nation's currency diminished in worldwide clout, so did the nation's ability to project other instruments of power.

Long known for a history of naval prowess, the British soon faced the United States in a confrontation over rule of the ocean. In 1952 after Churchill returned to power he sought to establish a British admiral as Supreme Allied Commander of the Atlantic. He pressed President Truman and the American staff for Britain to take lead “upon that western sea whose floor is white with the bones of Englishmen.”¹⁶ Despite the majestic history of the Royal Navy, the plea failed and Britain was relegated to assisting the United States.¹⁷ With her economic and military power waning, Great Britain’s fall continued.

The crown jewel of Britain’s influence in the Mediterranean was her joint control of the Suez Canal with France. Ironically, the United Kingdom’s share in the Suez Company was purchased from Egypt in a shrewd business move when Egypt’s debt-to-GDP ratio approached 200% in 1875.¹⁸ In 1956 Egyptian President Gamal Abdel Nasser nationalized the canal leaving Britain to conspire with France and Israel in an effort to regain control.¹⁹ The resulting Israeli invasion and blundering Franco-British response were as much a military fiasco as national black eye. International investors sensed a weakness in the United Kingdom and the pound and began to exchange the currency for dollars.²⁰ Tied to the fixed dollar exchange rate by the Bretton Woods agreement, British bankers were forced to deplete their dollar denominated currency reserves as people fled the pound for fear of devaluation. British leaders did not want to lower the pound’s value again fearing a second devaluation would drive the former colonies in the Commonwealth to utilize the dollar instead of the pound and greatly diminish her remaining global power. The British slunk back to the United States for monetary assistance.

Unfortunately, the Suez events occurred within days of a US presidential election and President Eisenhower was running on a platform of peace based on the ending of hostilities in Korea. Eisenhower was upset by the possibility of new hostilities in Egypt and held ultimate control

over British fate due to the financial institutions created after World War II. Eisenhower not only refused to loan the British money, but threatened a veto over any IMF loans as well.²¹ Without any other economic options, the once proud Empire immediately capitulated to the wishes of their lender.²² Great Britain performed an immediate about-face and withdrew troops so quickly that British soldiers were leaving while the invasion force was still landing prompting one general officer to state: “We’ve now achieved the impossible. We’re going both ways at once.”²³ Fittingly, Egyptian President Nasser referred to the Americans as “coming” and the British as “going.”²⁴

After the Suez Canal, Great Britain’s slide continued. Churchill’s lamented he “grieves that England in her fallen state can no longer address America as an equal, but must come, cap in hand, to do her bidding.”²⁵ This subservient posture, based on economic necessity by Great Britain, assisted in America’s rise to world power status. The Empire’s lack of global relevance was emphasized by the 1983 execution of Operation Urgent Fury in a British Commonwealth state ruled by Queen Elizabeth II. Despite a personal relationship between the President Reagan and British Prime Minister Margaret Thatcher, she did not hear of the operation until hours prior to execution. She personally objected to the president stating, “You have invaded the Queen’s territory and you didn’t even say a word to me.”²⁶ Although there was quiet seething regarding the affront, Great Britain acknowledged their fall from power by failing to even condemn the United States for the invasion.

Between 1945 and 1965 British rule of 700 million people was whittled to a mere 5 million.²⁷ Within one generation, the once great British Empire was effectively subjugated to a new global power which was ironically a former colony. After World War II Great Britain was left barren of ability to affect outcomes due to a staggering national debt and the dynamics of

international politics changed accordingly. This financial weakness acted as a lever for the rising United States to manipulate nations, treaties, institutions, and policies to gain a marked advantage. Roughly 65 years after the war, the United States now finds itself in a similar position to the British Empire it deposed. After ten years of war in Iraq and Afghanistan, a financial crisis in 2008, and the resulting recession, the United States is entering an all too familiar economic danger zone.

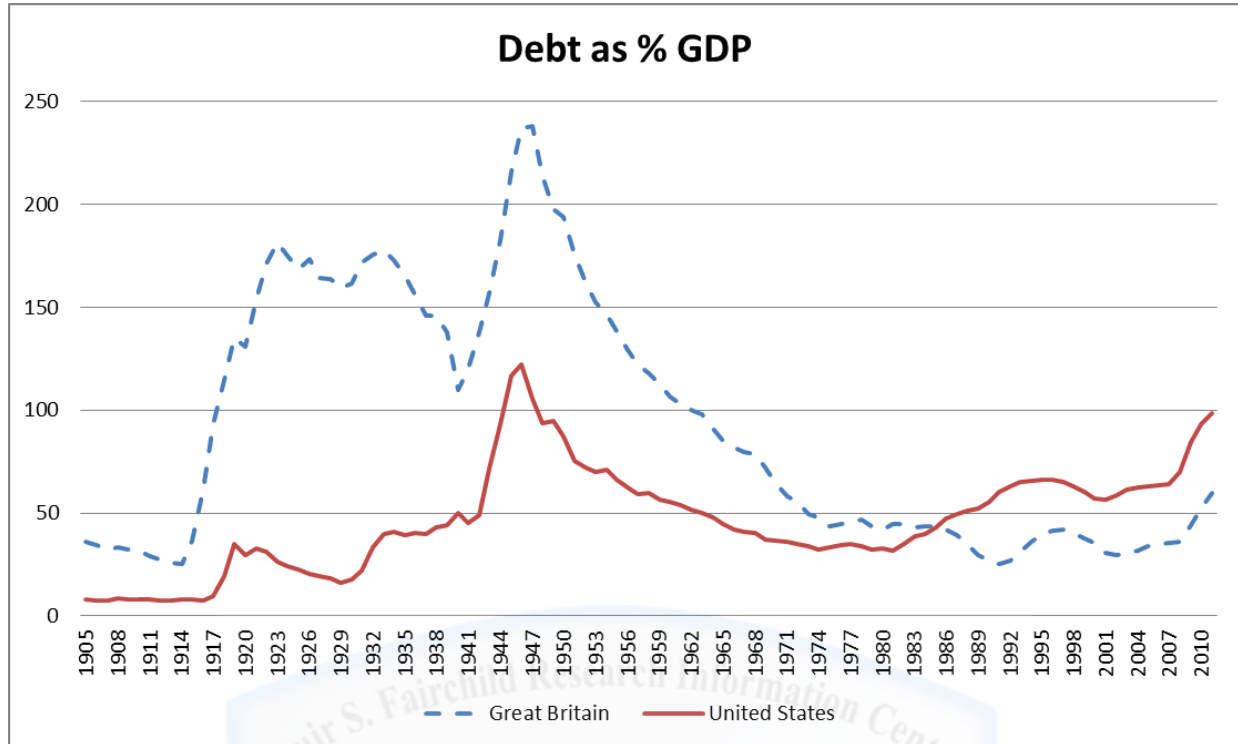
The United States

“I don’t want to be unkind or rude to the British but in 1841, when you acquired Hong Kong, you did not acquire it by purchase.” – President Roosevelt

“Let me see, Mr. President, that was about the time of the Mexican War.” – Reply by Oliver Stanley, British Colonial Secretary.²⁸

The United States was not subtle about despising British colonialism. The economic pressures applied during, and after, the war accelerated Great Britain’s loss of possessions around the world. If Britain’s economic position were better, she might have had additional options and resisted US pressure. Yet, there is no choice for a country which is fighting for its very existence. It must fight for survival because at the end of the day if the country is destroyed, then the debt fails to matter anyhow. In this regard, Great Britain had no other options during World War II but to fight on and deal with the consequences later. Those consequences required decades to play out and ended the Empire but the alternative was even less appealing, ask the people of Poland. British government debt peaked around 230% of Gross Domestic Product in 1947 (See Figure 1).²⁹ Thirty years later the nation’s debt returned to a sustainable level but only after massive debt restructuring, monetary devaluations, and significant inflation. Each of these debt reduction tools only further transitioned power to the wealthier United States.

Figure 1 – US and UK debt as % GDP:



On initial glance, the United States currently appears to be in better shape than both countries after World War II. According to the Congressional Budget Office's January 2012 budget outlook, the gross US debt to GDP ratio at the end of 2011 was merely 99%.³⁰ The most recent increase in debt is mainly due to the 2008 financial crisis and resulting government intervention. Whether the 2008 crisis was as serious of threat as Great Britain faced in 1939 is a topic for another day, but nonetheless national debt increased greatly. Unfortunately, other circumstances make the US position unsustainable even at a lower debt-to-GDP ratio. True understanding of the situation requires a discussion of a few economic principles.

$$\text{Domestic Private Sector Financial Balance} + \text{Governmental Fiscal Balance} - \text{Current Account Balance} = 0$$

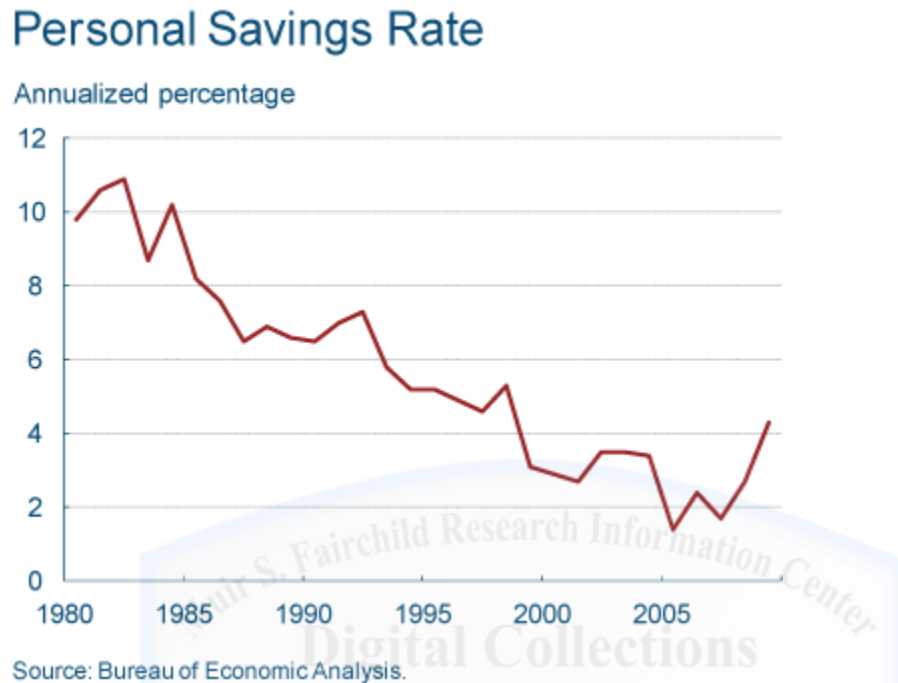
The above equation represents a state's economy divided into three sectors of private, government, and exports. The private sector balance represents whether individuals and

businesses are saving or borrowing. The governmental balance represents whether the government is issuing debt or paying it off and the current account balance is the trade or deficit surplus.³¹ So, if imports and exports are even (i.e. zero) and the government is running deficits, then the private sector must be saving and vice versa. In today's world, for the government and private sector to simultaneously pay down debt, the country must run a trade surplus. This simplified math problem is instrumental to an understanding of the problems facing the United States and world economies today. Be advised, this equation represents an identity of accounting and is much more than a theory. As financial expert John Mauldin, states, "If it is wrong, then five centuries of double-entry bookkeeping must also be wrong."³² There is one limit to this equation, it represents a closed system. One way to 'game' this system is to increase leverage or borrow money from abroad. If these methods are used debt can accumulate quickly but the 'game' only works in one direction. When any of the players need to deleverage, the accounting identity holds true and the difference must be absorbed in another sector or by changing imports/exports.

Why does this accounting identity matter? First, it helps explain how both the United States and the United Kingdom could both create such enormous deficits during the Second World War. In this era, the world was exiting from the Great Depression. The private sector had worked to pay down debt and individual households and businesses had high savings rates. These high savings rates translated in an ability of the federal government to borrow money when war consumed the world.³³ After the war, a United Nations report estimated the average personal savings rate between 1942-1944 as 16.9% in the United Kingdom and 21.9% in the United States.³⁴ Using the accounting identity, the higher savings rate of the 1940s equated to

the government's ability to increase debt and create a correspondingly higher debt-to-GDP ratio. Compare those figures with a personal savings rate below 5% for US citizens today (Figure 2):³⁵

Figure 2 – Personal Savings Rate:



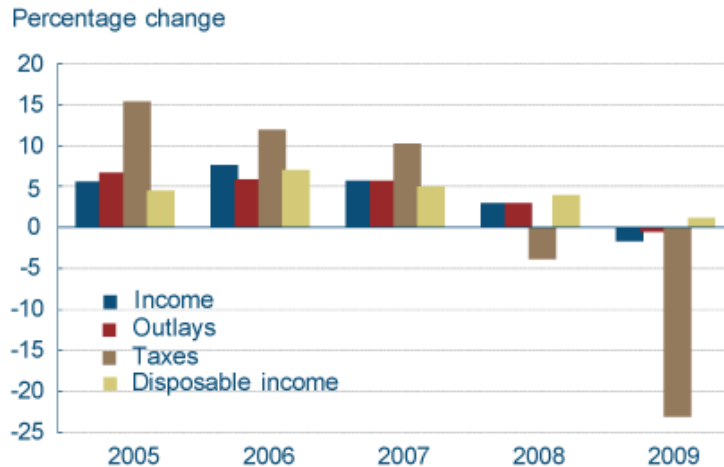
An important connection between these numbers is the *ability* of citizens to save. In 1943, with a personal debt-to-GDP ratio of only 13%, individuals had an enormous capacity to save.³⁶

Today, household debt is roughly 87% of GDP which nullifies a significant amount of personal income in order to pay debt servicing costs, or interest.³⁷ In short, individuals do not have the ability to absorb government spending. There appears to be a light at the end of the tunnel based on the uptick in personal savings in the past few years, but even this is only an accounting trick.

In reality, as the accounting identity predicts, personal savings and government revenue is directly correlated. Tax breaks passed in late 2008 transferred money from the government to the private sector. Figure 3 (below) shows how the decrease in taxes significantly assisted the personal savings rate. From a bookkeeping perspective, whether a government chooses to lower taxes or spend more money, the net effect is the same resulting in increased government debt.

Figure 3 – Changes in Personal Savings Rate:³⁸

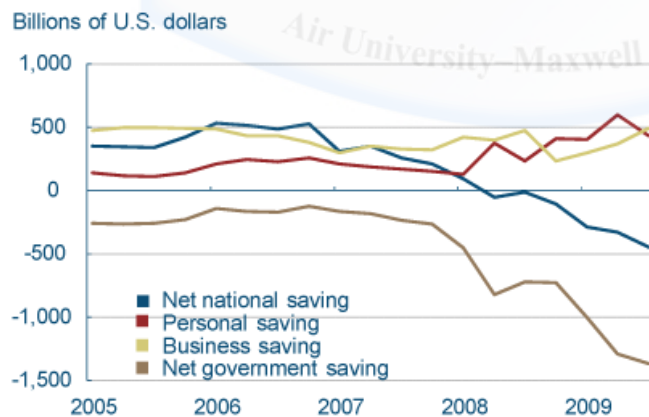
Percentage Change in Components of Personal Savings Rate



Source: Bureau of Economic Analysis.

Figure 4 – Net National Savings:

Net National Savings and its Components Quarterly, 2005:Q1 to 2009:Q3



Source: Bureau of Economic Analysis.

Returning to the accounting identity, the factors not yet discussed are corporate savings and the import/export business. Unfortunately, today's corporate savings do not make up for the massive amount of government spending. The resulting net savings rate for the United States is now into negative territory for the first time since the Great Depression (Figure 4).³⁹ Essentially,

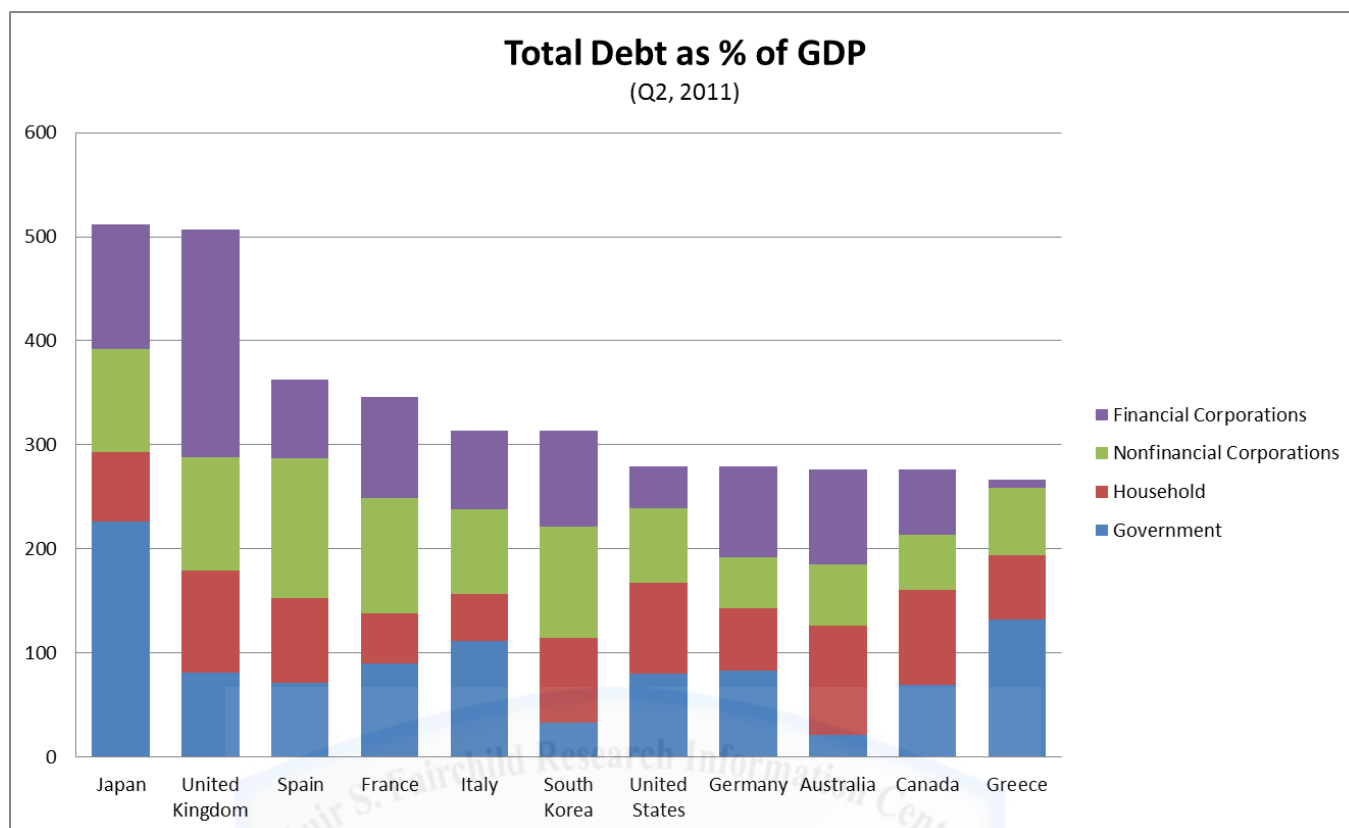
the total amount of US debt exists due to a continuing trade deficit and the willingness of other countries to hold US debt. This enabled the government, households, and non-financial corporations to create a 99%, 87%, and 72% debt ratio respectively.⁴⁰ Fortunately, individuals and governments around the world are currently willing to purchase US debt for a very nominal interest rate. Like an individual family however, there is a point where debt is too large to pay back. If the international community feels that this moment is nearing, a flight from the dollar may look very similar to the run on the British pound in 1956. To avoid this, the debt ratio must reverse course. As discussed before, since the both the private and public sector is in debt, the accounting identity reveals that payback is simple; the United States only needs to run a trade surplus. If only the world's balance sheet were so simple.

The World Situation

"The strong do what they can and the weak suffer what they must." -
Thucydides⁴¹

After the world-wide financial crisis unfolded in 2008, the United States was not the only country to utilize government spending in an attempt to stabilize banks, individuals, and corporations. Unfortunately, even before the crisis, government, household, and business debt was increasing at a steady pace in most Western economies. New tools for bank leverage and cheap labor from the third world allowed debt to accumulate in all sectors of the world's leading economies. Figure 5 depicts the total debt accumulated for several nations as calculated by The McKinsey Global Institute (notice US government debt is only 80% of GDP as the data is from the second quarter of 2011):⁴²

Figure 5 – Total Debt as a percentage of GDP:



A debt-to-GDP ratio of this magnitude across so many of the world's leading economies is staggering. At 500% of GDP, if all debt in Japan and the United Kingdom is loaned at 5% interest, 25% of annual GDP is wasted servicing debt. Many of these countries are now in the process of discussing deleveraging their positions, or paying down debt. There is only one catch, based on the accounting identity discussed earlier either the private or corporate sector must increase their borrowing, or the country must run an export surplus. Examining the countries listed above, the private sector is in no position to absorb government debt and who can they export to? All of these countries cannot run a trade surplus at the same time unless third world countries suddenly decide to import trillions of dollars of goods.⁴³ The accounting identity exposes a massive problem for the future of these economies. Countries with an abundance of natural resources or low cost labor are accumulating wealth while Westernized governments spend. To see this in graphical form, the International Monetary Fund compiled a world map

displaying the debt-to-GDP ratios for countries in 1932 and 2009 (Figures 6 & 7, country sizes are proportional to the GDP level in purchasing power parity terms).⁴⁴

Figure 6 – Global Debt-to-GDP Ratios in 1932

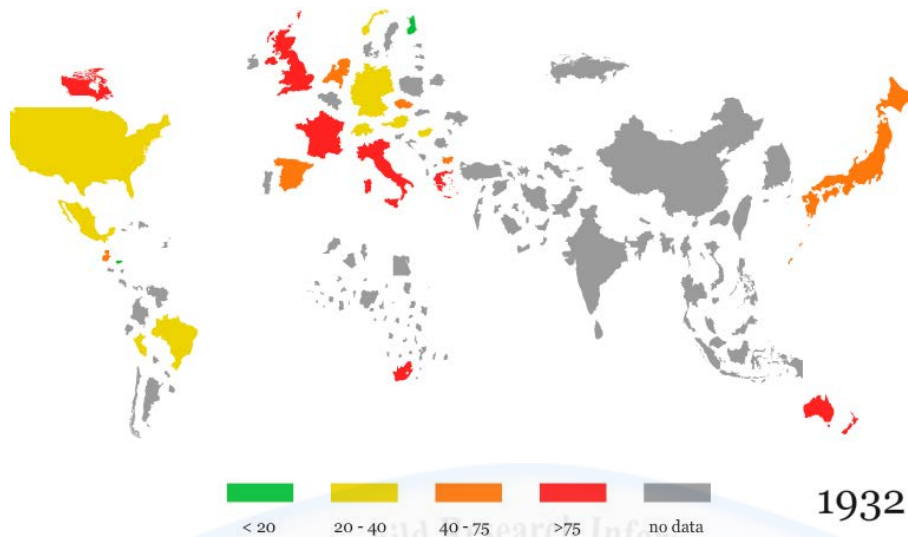
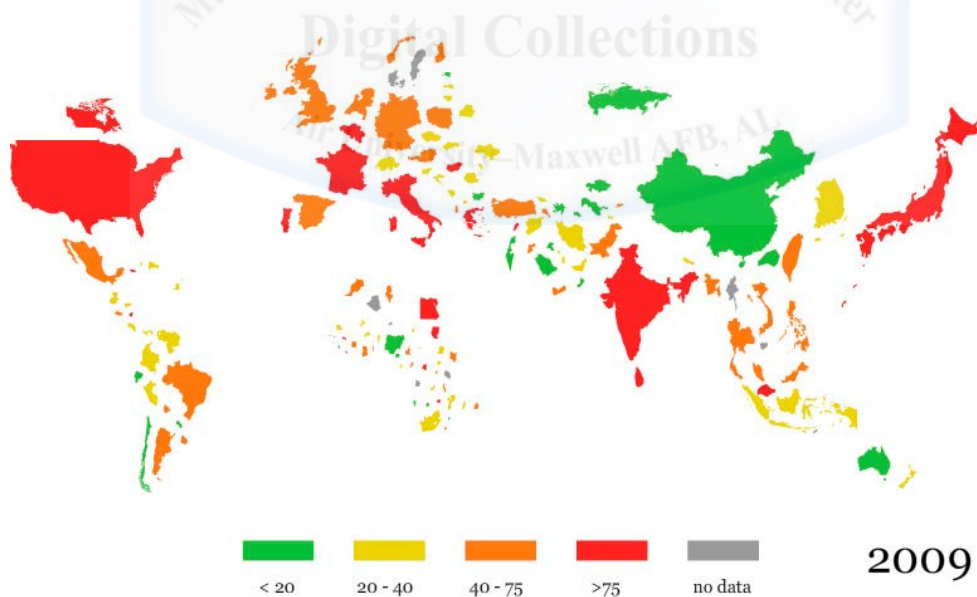


Figure 7 – Global Debt-to-GDP Ratios in 2009



The resource rich and export driven economies undoubtedly enjoy their accumulation of wealth and power. They are unlikely to begin running a trade deficit anytime soon leaving the Western world with few options to exit the morass of their debt. While the United States is better off than many nations in terms of both government and total debt, it is still treading

dangerous waters. Debt accumulation, especially in foreign hands, provides leverage for other nations manipulate and affect international outcomes. In addition, even if a specific nation does not exert pressure there is still the possibility the global bond market will determine the risk of holding US assets is excessive. This revolt of the bond market could spike interest rates very quickly which amplifies debt problems or makes the country insolvent.

Debt is undoubtedly a function of trust. Unless there is pure coercion or theft involved, a lender must have confidence in being repaid prior to extending credit to an individual or a nation. Maintaining lender confidence is critical, especially when nations depend on government debt being continued indefinitely. The only requirement is an active trader to purchase the government bond when the previous one expires. Like a consumer getting a second credit card to pay the first, or more accurately a Ponzi scheme, the government can even sell new bonds to pay the interest expenses to their previous bond owners. According to Bank Credit Analyst, the process will only end if “foreign investors ever turn their back on U.S. assets, triggering capital flight out of the dollar and robbing U.S. authorities of any room for maneuver.”⁴⁵ Ultimately, the government has no say when the music will stop. Foreign governments and individuals only hold US dollars and purchase US bonds based on the solid reputation of the government and a faith that US obligations will always be paid. No one can say how far this faith can be stretched. The foremost experts in this area are Carmen Reinhart and Kenneth Rogoff who summarize the precariousness of confidence, “Highly indebted governments, banks, or corporations can seem to be merrily rolling along for an extended period, when bang! – confidence collapses, lenders disappear, and a crisis hits.”⁴⁶ China alone holds over \$1 Trillion in debt and some estimates claim up to two-thirds of dollars circulate outside the United States.⁴⁷ Should the international community lose faith in the US government; the dollar’s collapse will be spectacular.

In recent years, as the amount of debt climbed, the long term stability of government debt also decreased. When interest rates began to drop over the past twenty years governments shifted from long term to short term bonds. Governments always pay less interest on short term bonds, if rates remain the same or are dropping, it makes sense to take advantage of the lower rate. For instance, at the end of 2011 the US government paid 2.8% interest on a 10 year treasury note and only .1% on a 3 month treasury bill.⁴⁸ If a government knows the current 10 year rate is 5%, why lock in a 10 year bond at this rate if they are certain it will be 4% next year? This strategy reduces interest payments to service debt in the near term but is a systematic vulnerability as rates rise. Also, when debt is in shorter period loans, lenders must evaluate the strength of the country more often which is a recipe for disaster. The US Treasury Department reported in September 2011 that only six of fifteen trillion dollars of US government debt was in long term (over two year) securities.⁴⁹ In other words, if confidence in the US government is lost by investors, over half of the debt will require new bonds within two years at a higher rate causing interest payments on the debt to rise quickly. Higher interest payments impact the budget, further affecting confidence in the government, potentially pushing rates even higher.

In addition to the intricacies of the bond market, an aging population combined with the democratic process complicates debt concerns for most world governments. The most recent CBO outlook highlights the growing share of the dollars required to pay US entitlement programs.⁵⁰ As the population ages and individuals transfer from working status to retirement, the government loses revenue from income taxes and must pay out the promised benefits. As an added drain, these individuals begin withdrawing funds from other retirement accounts which are often at least partially invested in US federal debt. The poor economy is increasing the problem of an aging population as the recession is being blamed for a fertility rate of only 1.9 children per

female in the United States. This number is below the replacement level for the population of 2.1 children per female meaning without immigration the US population would shrink.⁵¹

The combination of increasing Western world debt, trade deficits, a vulnerability in the bond market, and an aging population all create cumulative potential for crisis in the United States. Although a crisis is not a foregone conclusion it is worth examining the potential fallout of financial turmoil for the United States.

United States' Risks and the Military Connection

"I've said many times that I believe the single, biggest threat to our national security is our debt, so I also believe we have every responsibility to help eliminate that threat," - Admiral Mullen, Chairman of the Joint Chiefs of Staff⁵²

The crisis of confidence described by Reinhart and Rogoff is exactly what occurred to Britain during the Suez crisis of 1956. Investors and speculators smelled blood in the water and raced to either protect assets or create financial gain from the troubles of Britain. Between July and December the nation shifted from an offensive military footing to full retreat based on supplication to their lending partner's wishes.⁵³ There is a plethora of ways US financial vulnerability may play out but it is worth imagining a few situations which could occur while discussing some items which are already happening to discern the range of possibilities. Like the British Suez example, the scope of the problem relates significantly to military power and the future distribution of world power.

Imagining the circumstances of a future US financial dilemma are fairly simple. Glancing at the IMF's depiction of the global economic situation in Figure 7, it is possible to imagine China arriving to 'assist' the United States out of a financial hardship much in the same way the United States 'assisted' Great Britain. A quick look at the cumulative US debt in Figure 5 also helps to emphasize that a crisis is not completely imaginary. Greece's total debt, before

their recent restructuring, was less than the United States and they are already experiencing a financial crisis. Now, how would a disaster start? Look at Japan whose government debt alone is roughly 230% of GDP. Currently in 2012, even at 1% interest rates, Japan spends half of its income tax receipts on paying debt interest.⁵⁴ Imagine for a moment that the bond market refuses to buy Japanese bonds at a rate lower than the United States. If Japan's bonds jumped to the CBO forecast United States' 10 year rate of 2.3% the country would pay more in interest each year than it collects in income taxes.⁵⁵ If it is forced to pay the 5.75% rate of Australia, who has miniscule debt, the country will be insolvent.⁵⁶ Imagine for a moment that the Japanese government chose to devalue their currency dramatically in order to stimulate exports and reduce the relative value of debt. Since Japan is the world's fifth largest economy (if the European Union is taken as a single economy) a panic ensues as bond holders realize that even governments known for stability are in jeopardy of default.⁵⁷ Theoretically, interest rates could jump around the world, causing smaller nations to collapse first as they are deemed a higher risk and their interest payments skyrocket. US banks are initially safe as they currently claim to be minimally exposed to debt from countries like Portugal, Ireland, Italy, Greece, and Spain (PIIGS).⁵⁸ European banks from larger nations like France, Germany, and Great Britain implode however as they lose value on government bonds sold to PIIGS. Without these large banks, the seemingly stable countries like France and Germany cannot roll over debt as the banks are not there to purchase government bonds. As the larger governments and banks of Europe fall into crisis, US banks become exposed to the crisis which quickly could sweep the United States and the world into a global depression worse than 1929. While somewhat fantasy, the numbers concerning Japan are fact and the globalization of international banking makes this scenario not too unreasonable.

Assume China steps out of the shadows to offer the United States loans to help emerge from the crisis. IMF economist Arvind Subramanian proposes that given the correct circumstances, China could dictate austerity measures within the United States, or even demand the abdication of US naval bases from the Western Pacific as preconditions for the loan.⁵⁹ If the situation is dire enough, an equally logical demand could be US acknowledgement of China's reunification with Taiwan. When a nation is in need, the lending nation is able to dictate virtually any terms. This happened between the United States and Great Britain after the Suez Canal scenario. In more recent events, Germany dictated internal pension cuts, tax code overhauls, and privatization of state assets, among other drastic measures, prior to agreeing to the bailout of Greece.⁶⁰

As an alternative to acceptance of Chinese demands, the United States may opt to default on external debt leaving China with massive losses. Even in this situation China holds more cards than most people imagine. With the world in chaos, as a wealthy nation China could easily tempt indebted nations like Japan, Italy, and Great Britain with money to help escape the financial crisis. Of course these loans could be dependent on the seizure of US assets and bases in each respective country. Legally, China would be justified in utilizing international organizations and countries with highly developed legal systems to secure US government property abroad.⁶¹ As these needy nations adhere to the rule of law, China could potentially use these assets as a form of recourse due to the massive default perpetuated by the United States. Imagine China flying squadrons of US F-16s from Italy, US F-15s from England, all the while supplying bases with US C-130's from Japan. If capturing US assets failed, there is historical precedent for China to resort to force in an attempt to gain repayment. Great Britain invaded Egypt and Istanbul after defaults in the late nineteenth century and the United States' Venezuelan

efforts of the mid-1890s were partly motivated by debt repayment concerns.⁶² China flying US aircraft is a bit far-fetched, yet there is no telling how low a needy nation might stoop to protect national interests and how far an empowered nation would push them.

While Britain used military might, or hard power, to extend its overseas domain the United States chose to envelop nations with soft power and economic might to extend influence. To some, this use of soft power resulted in shackling US allies with “golden chains” as dependency on US assistance and dollars buoyed smaller nations.⁶³ Another scenario includes flight away from the dollar in the international market. Today, when a nation quickly shifts toward the use of a foreign currency as a “transaction medium, a unit of account, and a store of value” it is called “dollarization.”⁶⁴ While the possibility of US citizens using another medium of exchange is exceedingly remote, as the United States falls deeper into debt it is easy to see how transactions in the international community could shift away from dollars. In reality, Iran has already called for oil transactions in a currency other than dollars and is currently in discussion with India and China to conduct oil trades using gold as the medium.⁶⁵ There is quite a bit of irony that US sanctions on a rogue nation may accelerate the international market away from the dollar as a reserve currency. In any event, a decrease in the dominance of the dollar and countries openly violating US backed sanctions are both a blow to US soft power. This power is sure to be completely devastated if the United States fails to uphold debt contracts. Default is only an option to US debt woes with a corresponding isolationist agenda.

In terms of hard power, the relationship between military capabilities and economic performance is well documented by John Mearsheimer in *The Tragedy of Great Power Politics*. Mearsheimer credits “abundant wealth and a large population [as] prerequisites for building [a] formidable military power”.⁶⁶ If the United States is not able to stabilize debt, military power

will inevitably wane as the national wealth is surpassed by other nations and the requirement to pay interest on growing debt erases dollars from military funding. On the opposite side of the Pacific, if China is able to achieve a wealth per capita rate of only half the US rate then their GDP will more than double the US economy.⁶⁷ China's military spending will grow accordingly and with increased military capabilities Mearsheimer suggests they could seek a policy similar to the Monroe Doctrine demanding the United States remove their influence from the Asian region.⁶⁸ Given the wrong circumstances, the United States may not retain the international soft power or military might to deny their request.

Recommendations

*"Gentlemen, we have run out of money; now we have to think."
– Sir Winston Churchill*

Despite all the potential hurdles, the US situation is not yet gloom and doom. There is plenty of room for a crisis to occur but there is also time to stabilize the economic foundation of society and prevent catastrophe. Although the civil-military relationship within the United States restricts the military's role in the national economic debate, there is still a part for military leaders to play. National military commanders must understand the nature of economic problems facing the US leverage the public trust to ensure the US economic enemy does not continue to grow in strength. The following are a few recommendations to shape the battlefield in the upcoming US debt war.

1. Like a counterinsurgency operation, this is not a short term problem. Accept this fact and move on. While the national debt has doubled within a few years, it will require decades, not years, to repay these enormous sums of money. Acknowledgement of this fact implies limited military budgets for the foreseeable future.

2. Educate military officers. Start by employing at least one economist at each of the service Intermediate Developmental Education and Senior Developmental Education schools. As the problem will persist for a long period of time, at least some economic background at these schools can help encourage thought, discussion, and research in an effort to develop new ideas for the way forward. Similarly, lead troops to the economic discussion by using tools such as the CSAF reading list. Include books on this forum immediately, like Carmen Reinhart and Kenneth Rogoff's *This Time is Different* which is prevalent in virtually all discussions of the current financial crisis. Although the topic is difficult for non-economic trained minds, not understanding the problem is not an option.

3. Stop ignoring the full impact of the Budget Control Act. Yes, the currently proposed \$487 billion in cuts was very painful and only recently completed. While these cuts are agonizing, consider them done and move on to the next challenge. Under the 'sequestration' provision of the bill, an additional \$500 to \$600 billion in cuts are required beginning in January of 2013.⁶⁹ The current military leadership mantra appears to be wavering between assuming these cuts will not happen and repeating the catch phrase "hollow force".⁷⁰ Encouraging congress to renege on hard fought budget control measures by chanting slogans from a bygone era are less than helpful. The current deplorable state of national finances is outlined in the paper above; if sequestering does not occur and current tax cuts are extended, the CBO estimates by 2035 the national debt would equal 190% of GDP.⁷¹ The US economy could not survive this scenario. The nation is spending more each year than it receives in revenue and needs to stop running deficits. The defense budget accounted for over 19% of the budget in 2011 and will still account for nearly 18% of the budget if sequestration happens in 2013.⁷² The budget deficit must be dealt with and the pain will continue to be shared by the military. In addition, the last

election was heavily influenced by the tea party movement whose mantra involved making government smaller. In this election year there is little chance a bill will be allowed on the floor to reverse sequestration as both republicans and democrats fear the last election's emphasis on decreased spending. If the cuts of sequestration are a foregone conclusion and national necessity, accept the results and plan for the consequences as early as possible. By working ahead of the problem, there may be a way to prepare for the coming battles.

4. Accepting smaller budgets in the near term does not mean the funding fight is over for military leadership. While the Budget Control Act was indeed a battle, the actual war is between military funding and growing entitlement expenses. The goal of military leadership should be to advertise two issues. First, announce that the military has accepted all of the required cuts under the budget control act (including sequestration) because the Department of Defense deems the national debt as a major threat to national security. Outline what military size and shape the budget will buy the United States and begin the discussion on appropriate adjustments to national priorities. This maneuver provides military leaders the moral high ground when in reality they merely accepted the inevitable. If congress cannot live with the more limited capabilities the military can provide, then they will be forced to make other choices. This point must be made before the election. Second, begin a ruthless campaign regarding the global benefits provided by the US military and the need to stabilize military spending without any further cuts. Specifically, military capabilities secure international waterways, deter aggression, and maintain peace which increases productivity worldwide and benefits the national GDP. The very next breath must contrast military cuts with the growth in entitlement spending. Public health care and individual retirement have been handled successfully by the private sector for decades whereas the military security of the United States cannot be privatized. As the two charts below depict (Figures 8 &

9), military spending has taken massive cuts and is on a well-controlled and sustainable vector. Social Security and government health care programs on the other hand, are poised to consume the national budget and rob the nation of economic power. According to the Congressional Budget Office estimates, Social Security spending, health care benefits, and interest on the national debt will account for five and one-half times the department of defense budget in 2022.⁷³ The military can, and must shape this argument for the public and congress. Currently the military enjoys a significant amount of trust from the American people. In a Gallop poll from June of 2011, 78% of citizens held a “great deal” of confidence in the military whereas only 12% could say the same for Congress.⁷⁴ Military leaders need to leverage this trust and emphasize that any further reductions to defense spending without tackling the difficulties of these programs is unconscionable and will endanger the United States.

Figure 8 – CBO Budget Forecast:

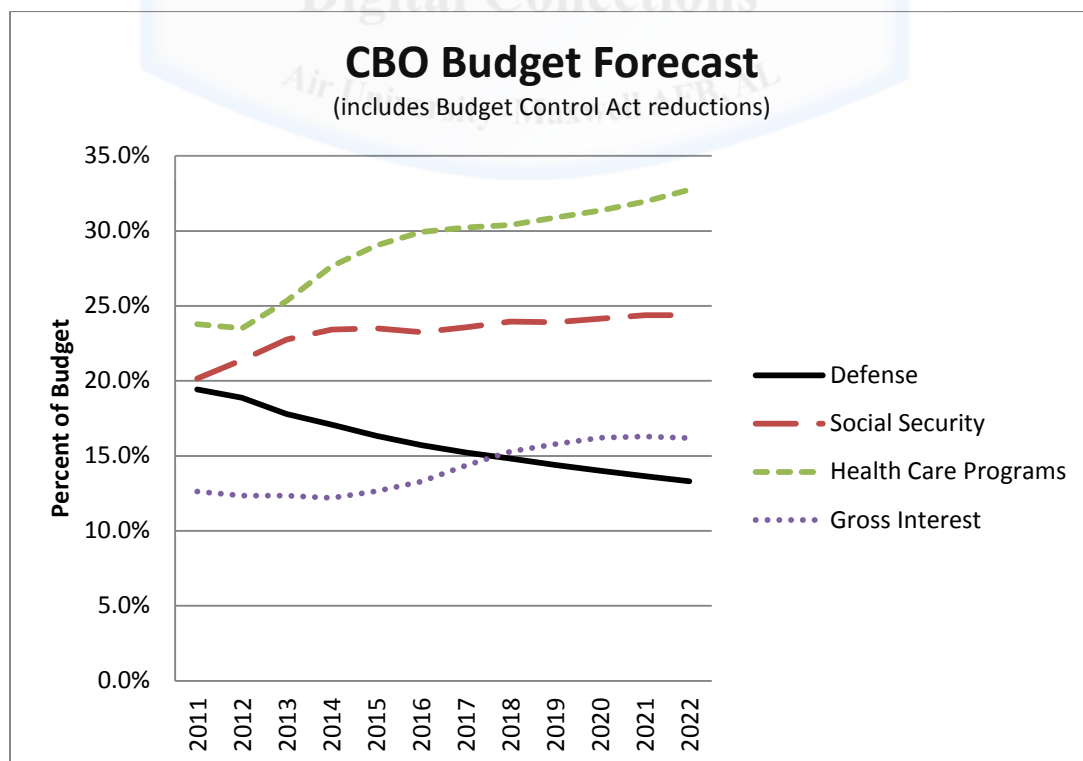
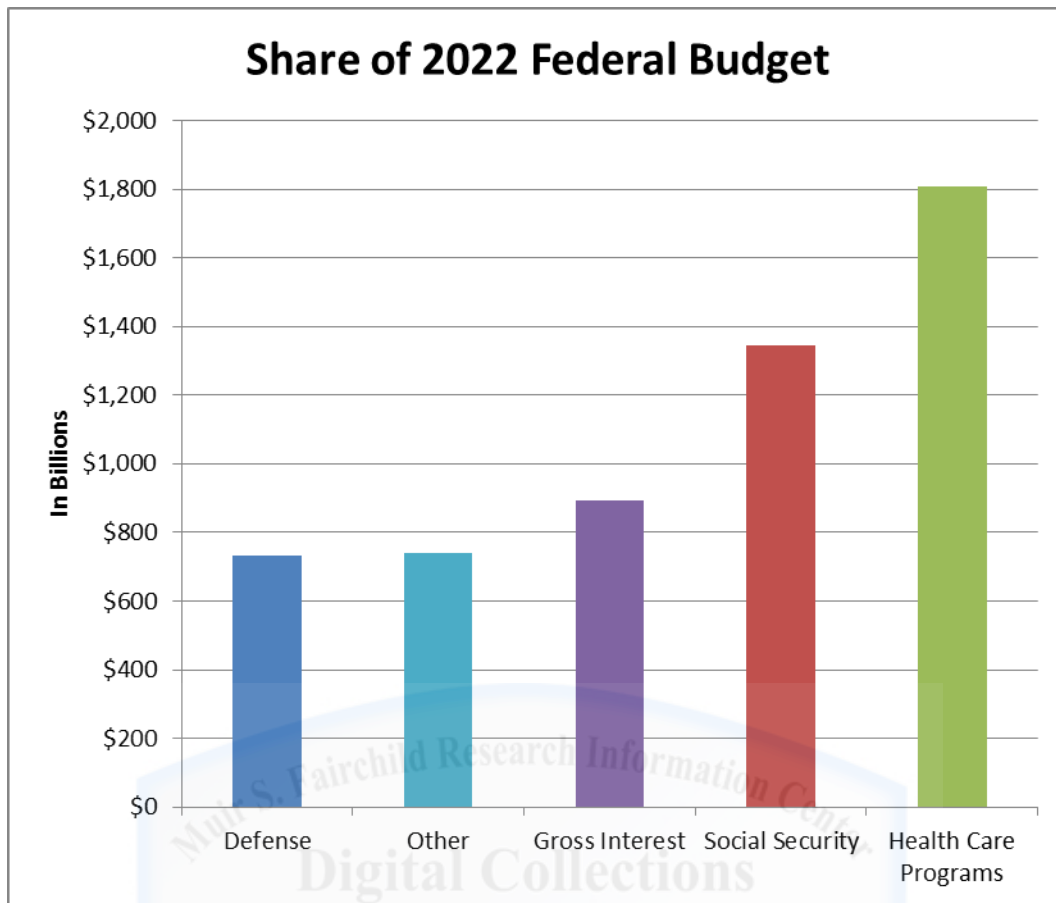


Figure 9 – CBO 2022 Federal Budget:



5. Approach the problem as a unified Department of Defense protecting the greatest nation on earth, not four tribes. Given the conditions above, that (1) the additional defense spending cuts of the Budget Control Act are going to occur and (2) the long term funding battle is between entitlement spending and even further defense cuts, then military leaders must prevent inter-service rivalry at all costs. Petty arguments concerning pet projects will expend invaluable energy internally instead of against the larger national threat. A holistic approach to defense is the only solution in these times of austerity. This may mean that expensive programs like the Joint Strike Fighter are called into question. In the case of staggeringly expensive outlays, scrutiny is required and the examination must consider whether moderate capability gains are truly worth the cost. Instead of hunkering down to protect service budget allocation, each program must stand on its own merits against potential threats and in comparison to joint

capabilities. Some programs will survive the cut, while others may not. Military leaders from all services must understand the lesson which Great Britain learned at the Suez Canal; economic vulnerability can stop a military expedition without firing a shot.

Conclusion

“...there are people who seem to think that there are no intermediate steps between the Empire On Which the Sun Never Sets and the fate of Nineveh or Byzantium.” – The Economist, 1957 after Suez⁷⁵

The decline of Great Britain after World War II is well documented and indisputable. The question is when was the collapse inevitable? The loss of colonies provided a glaring reminder of the empire's demise, but that was a symptom, not the cause. Britain's massive government debts preceded her fall from grace and amplified other global effects to unravel the empire. The United States used this economic weakness as leverage to achieve their desired end-state, often at the expense of Great Britain.

Today, the United States and most Western governments face a systematic and crushing burden of debt. While debt is fairly easy to accumulate, economic principles dictate how it must unravel and stipulate that all nations cannot deleverage at the same time. The possibility of sharply rising interest rates and aging populations add to the difficulties facing the United States and other Western governments seeking to pay down debt.

Due to the weight of government debt, the United States is increasingly at risk of economic exploitation by outside actors. The United States' massive amount of debt decreases her economic influence abroad as wealthier nations may attempt to purchase alliances with countries that were once shackled by “golden chains”. In a worst case scenario, a nation who is not saddled by national debt may require unacceptable concessions prior to providing financial

assistance. The United States utilized this form of leverage to manipulate Britain through the Destroyers for Bases agreement, the Atlantic Charter, the Anglo-American loan, Bretton Woods agreement, and in the Suez Crisis.

In the current environment military leaders face an uphill budget battle. In order to fulfill their oath to defend the nation they must understand the threat to national security posed by debt. This is a long battle requiring decades to reverse debt accumulated in only a few years. Education of the military is the first step to preparing the battlefield including emphasis of economic topics during military education. Military leaders must also embrace the sequestration cuts required by the Budget Control Act immediately in order to present the impacts prior to the election cycle and shape the future battle between entitlements and military funding. To win in this spending war, the military must present a unified front to the public and bury inter-service rivalry for the good of the nation.

On the 16th of February the United States received a warning from Egypt. The Muslim Brotherhood, who controls the majority of the Egyptian parliament, stated that if the United States ceased to continue its yearly payments of over \$1 billion dollars Egypt would reconsider their peace treaty with Israel.⁷⁶ This declaration highlights the importance of economics to international relationships and how brittle America's "golden chains" can be. It also juxtaposes an ultimate irony. When the British were garrisoned along the Canal Zone in 1951 it was the Muslim Brotherhood who instigated attacks and accelerated events leading to the Suez Crisis in 1956.⁷⁷ National power and military strength is unquestionably dependent on economic stability. British capitulation to US demands occurred when they were the largest debtor nation in the world. Today the United States holds this title due to a debt accumulation of roughly \$14,700,000,000,000.⁷⁸ The United States is fortunate our Suez Canal crisis has not yet

occurred but without a change to implement sustainable economic policies the hour will soon arrive.

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